Legal Backgrounder

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# FEDERAL COURT HOLDS BANK REGULATORS ACCOUNTABLE FOR BREACHING COMMITMENTS

by

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The Office of the Comptroller of the Currency ("OCC") is the oldest and most venerable bank regulatory agency in the United States. Established in 1863 as a bureau of the United States Department of Treasury, even its official statutory reference in the United States Code has the kind of panache associated with few federal institutions.

While the OCC remains, technically, a constituent agency within the United States Department of the Treasury, the Comptroller's office operates with *de facto* autonomy in carrying out its principal function: the plenary, so-called "cradle-to-grave" oversight of some 2,200 national banks, and 56 federal branches of foreign banks. Not even the OCC's titular supervisor, the Secretary of the Treasury, may delay or prevent the Comptroller from issuing rules and regulations. 12 U.S.C. § 1.

Like each of the other federal bank regulatory agencies, the OCC operates within a regulatory culture of "presumptive infallibility," where its decisions and those of its examination and supervisory staff, as both a practical and legal matter, are often close to being unchallengeable, regardless of whether such decisions are "right" or, in some cases, even consistent with basic common sense. In fact, the OCC, like the other bank agencies, often asserts the protection of the aptly named "judicial withdrawal" statutes by which Congress seems to authorize the Agency to act without the burden of judicial review of its agents' conduct, whether unlawful, arbitrary, or irrational.[1] Such withdrawal statutes are not unusual in complex regulatory areas, and in the normal course serve to defer federal court review of agency action until the statutory administrative procedures are complete.

[1] The judicial withdrawal statute that generally applies to OCC actions is 12 U.S.C. § 1818(i), which provides: "except as otherwise provided [. . .] no court shall have jurisdiction to affect by injunction or otherwise the issuance or enforcement of any notice or order under [this section, or under section 1818o or 1818p-1], or to review, modify, suspend, terminate, or set aside any such notice or order" issued by the appropriate federal banking agency.

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Fortunately, the courts have recognized certain, albeit few, constitutional limits on an agency's ability to act within a hermetically sealed regulatory system, and the ability of Congress to completely insulate agency action from judicial review, notwithstanding the facial language of judicial withdrawal statutes.[2] The cases limiting the OCC's authority are few and far between, however, and even tales, well-known to many small and medium-sized banks, of egregious conduct by OCC agents do not often result in public accountability.[3] Given the very real risks and consequences of retaliatory and punitive action by regulators when their actions challenged, it takes both courage and resources to pursue even abusive conduct in court.

A recent decision of the United States Court of Federal Claims, based on a solid history of appellate and U.S. Supreme Court jurisprudence in the savings and loan area, has now recognized another potential avenue for oversight of OCC conduct — albeit, without raising the issue of judicial scrutiny of the OCC's ongoing regulatory oversight of a particular banking institution — in circumstances where investors were induced to put new capital into troubled commercial banks, or were required to agree to maintain capital ratios at certain levels higher than normal. Thus, individuals now have recourse when the Agency, through purported "regulatory action," reneges on the very promises made as part of, and to induce the investment package. *See Sinclair v. United States*, Case No. 00-598C (Fed. Cl. Apr. 16, 2001).

In 1999 the former Northwest National Bank of Gravette, Arkansas was reputed to be among the most poorly performing banks in the Southwest Region of the United States. In the first quarter of 2000, Northwest was acquired by Damian Sinclair, who for many years had successfully overseen a highly successful non-prime lending operation that specialized in making credit available to lower-income and minority borrowers, with loss rates significantly below industry norms.

To acquire the bank, Sinclair submitted a Change of Control application based on extensive and detailed business plans to direct the bank's lending into bulk purchases of non-prime loans, to restore its profitability. In addition to paying several million dollars for the capital stock of Northwest, Sinclair also would make a several million dollar investment of new capital into the bank. The Comptroller's office reviewed the business plans and approved the Change of Control application, including the projected business plan, but first conditioned that approval on Sinclair's written agreement to maintain future capital ratios at the bank at levels above those required by law.

Almost immediately after Sinclair took control of the bank (and changed its name to Sinclair National Bank), the Comptroller's supervisory staff began a concerted program of so-called "regulatory

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[2] *See Leedom v. Kyne*, 358 U.S. 184 (1958) (NLRB not insulated from judicial review of action in excess of its statutory authority); *Oestereich v. Selective Service System*, 393 U.S. 233 (1968) (notwithstanding judicial withdrawal statute, court had subject matter jurisdiction to review lawless conduct); *Railway Labor Executives Ass'n. v. National Mediation Board*, 29 F.3d 655, 662 (D.C. Cir. 1994) (where agency's actions were in "gross violation" of statute, judicial review was not precluded by withdrawal statute); *Avedis v. Herman*, 25 F. Supp. 2d 256, 262 (S.D.N.Y. 1998) (court had subject matter jurisdiction over challenge to Federal Employees' Compensation Act, notwithstanding preclusion statute, to review clear statutory violation).

[3] *See, e.g., Ridder v. OTS*, 146 F.3d 1035, 1041 (D.C. Cir. 1998) (showing of constitutional violation could authorize judicial review, despite the language of §1818(i)) ; *Leuthe v. Office of Financial Institution Adjudication*, 977 F. Supp. 357, 361 (E.D. Pa. 1997) (district court jurisdiction could lie, despite §1818(i), where "a serious constitutional question is presented"); *First National Bank of Scotia v. United States*, 530 F. Supp. 162, 169 (D. D.C. 1982) (declining jurisdiction when claims asserted did not "amount to such a palpable violation of substantial rights irremediable by the prescribed method of appellate review").

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action" with the purpose and effect of preventing Sinclair from carrying out the very business plan that was the basis of Sinclair's acquisition and investment in the Bank.[4]

Sinclair filed suit in the United States Court of Federal Claims pursuant to that court's Tucker Act jurisdiction over lawsuits for money damages against the United States for breach of contract.[5] The government responded with a motion to dismiss, in which it raised a battery of arguments that courts had rejected previously in other cases. First, the government claimed that jurisdiction could not be found unless Sinclair could establish the existence of a contract with the OCC. Rejecting that claim, the court found that a pleading, as Sinclair's, setting forth an express contract with a federal agency established subject matter jurisdiction over the claim.[6]

The court next turned down the government's several arguments that Sinclair failed to state a claim, which mirrored those already rejected by the courts when posited on behalf of the former Federal Home Loan Bank Board and the Office of Thrift Supervision, in opposition to federal liability in the well-known *Winstar* line of cases.[7] First, the government asserted that it could not be liable under contract for its approval of Sinclair's Change of Control application, which included a detailed description of the type and operation of the non-prime lending business Sinclair intended to undertake, and which was the basis for his acquisition of the institution. The government posited that, notwithstanding any review of the application and related materials, its "non-disapproval"[8] of Sinclair's application was merely a regulatory undertaking that did not rise to the level of a contract, and thus that no offer was made, and no acceptance was manifested by the OCC. Further, the government argued that the OCC official involved in the transaction — the regional Deputy Comptroller — had no authority to make such a contract. Indeed, in this regard, the government asserted that the OCC wholly lacked the authority to enter into a contract with Sinclair with regard to the acquisition of the bank.

In analyzing the government's claim, the court, citing the Supreme Court's decision in *Winstar*, found that regulators may enter into contracts not to exercise a sovereign power and, where such an agreement is abrogated by a subsequent sovereign act, the government may be liable to the party with whom it contracted. In such cases, an agency's regulatory actions under its sovereign powers do not impose liability on the government, but the failure to abide by the terms of the contract do. Contracts of

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[4] The full story is somewhat more complex, and involves reports that OCC personnel displayed a regrettable racial animus directed toward the low income borrowers who comprised Sinclair's principal constituency. *See* Complaint, *Sinclair National Bank v. OCC* (No. 00-2398) filed Oct. 4, 2000 (D.D.C.); *and see* Complaint, *Sinclair v. United States* (No. 00-598C) filed Oct. 4, 2000 (while the district court case was voluntarily dismissed, the Claims Court suit remains pending). With regard to this issue, the Comptroller of the Currency unfortunately sought to defend this objectionable conduct, including the alleged overtly offensive remarks about minority customers.

[5] Codified at 17 U.S.C. § 1491(a)(1), the Tucker Act provides, in part, that an action against the United States may be maintained if it is founded "upon any express or implied contract" with the federal government. In addition, Sinclair asserted a takings claim under the Fifth Amendment, which has been deferred by the court pending its determination of the Tucker Act claim.

[6] Denying the government's position on this issue, the court cautioned the government that its arguments went against, and failed to cite to, controlling authority on this point. *Sinclair*, Case No. 00-598C at 5.

[7] *See United States v. Winstar*, 518 U.S. 839 (1996), which confirmed the existence of the government's contractual liability for contracts according certain regulatory treatment of goodwill, which later were abrogated as a result of federal legislation that disallowed such treatment. Numerous cases alleging liability of federal banking agencies for breaching such contracts have been filed, and remain in various stages of litigation.

[8] The OCC approves the acquisition of banking institutions by investors under a statute that requires the Agency to issue "non-disapproval" letters. Thus, the OCC's approval is technically manifested by its "non-disapproval" of the acquisition.

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the sort at issue in *Winstar* can be express or, as held in another recent case decided by the Court of Federal Claims, implied-in-fact.[9]

Applying this rationale to the claims advanced by Sinclair, the court found that the plaintiff stated a viable claim for an implied-in-fact contract, based upon the pleadings, in which Sinclair alleged that the OCC agreed to allow the implementation of the targeted, non-prime lending business plan detailed in his pre-acquisition submissions to the OCC, which was the basis for Sinclair's investment in and acquisition of the bank. In exchange for his implementation of the lending program, the OCC required that Sinclair personally commit to maintain enhanced risk-based capital at ratios above and beyond those required by statute. Only because of Sinclair's written agreement to do so, in addition to his separate capital infusion into the bank, did the OCC issue the non-disapproval of Sinclair's application to assume control of the bank.

The court stated that the *Glass* case, currently on appeal, appeared to represent the "outer boundary of [the *Winstar*] contract rationale." In doing so, the court cautioned that the new generation of *Winstar* cases described by the implied-in-fact contract in *Sinclair*, while permissible under *Winstar* jurisprudence, could not be sustained to the extent that it transformed "any disagreement with agency exercise of its regulatory authority into a contract action." Accordingly, the court ruled that plaintiff could proceed, and could establish his contract claim by demonstrating, at the conclusion of discovery, "an agreement that contemplated (1) a specific regulatory forbearance by the overseeing agency (2) with respect to a specific activity (3) for a stipulated period of time." Importantly, the contract could be found, the court ruled, from the contemporaneous documents and circumstances that surrounded the transaction. Provided Sinclair makes this showing, the court found that the contract claim could be sustained, notwithstanding forseeable objections concerning authority and other issues raised by defendants.

The court also refused to dismiss Sinclair's promissory estoppel claim pending the completion of discovery, and delayed a ruling on Sinclair's alternative takings theory pending resolution of the contract claim.

The court's ruling in this case is a welcome step toward requiring agency accountability for actions taken by federal banking authorities and officials. As the facts of this case illustrate, the government simply cannot seek out, or induce investors to relieve federal liabilities on the basis of illusory promises, only to later retract those promises with impunity, whether by hiding behind judicial withdrawal statutes or misleading investors about the officials' authority to permit or structure the deal. Evident from the facts of this case, the OCC well knew the intent of the acquisition and the nature of the lending. Otherwise, there would have been no basis for negotiating and structuring the particularized enhanced capital ratio plan for the tiny ($55 million) bank. And absent approval of the business plan that was the foundation of Sinclair's business offer to rescue the failing bank, there would have been no reason for him to make a gratuitous multi-million dollar investment in the federal banking system. The OCC should be held accountable for reneging on its promise, and the arguments advanced on behalf of the OCC in this case should be soundly defeated.

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[9] *See Glass v. United States*, 44 Fed. Cl. 73 (1999), *appeal pending*, No. 00-5137 (Fed. Cir.). In *Glass*, the Federal Court of Claims determined that documentary evidence established an implied-in-fact contract with the government under which the FHLBB agreed upon certain regulatory treatment of goodwill as found in the *Winstar* cases based upon express contracts. While embracing these tenets of *Glass*, the court expressly disagreed with the *Glass* court's holding to the extent it held that an agency's "non-disapproval" of a proposed course of action, alone, was sufficient to establish the existence of a contract. *See Sinclair*, Case No. 00-598C at 12.